

(5) In determining whether a distribution or a series of distributions has the result of a disproportionate distribution, there shall be treated as outstanding stock of the distributing corporation (i) any right to acquire such stock (whether or not exercisable during the taxable year), and (ii) any security convertible into stock of the distributing corporation (whether or not convertible during the taxable year).

(6) In cases where there is more than one class of stock outstanding, each class of stock is to be considered separately in determining whether a shareholder has increased his proportionate interest in the assets or earnings and profits of a corporation. The individual shareholders of a class of stock will be deemed to have an increased interest if the class of stock as a whole has an increased interest in the corporation.

(c) *Distributions of cash in lieu of fractional shares.* (1) Section 305(b)(2) will not apply if—

(i) A corporation declares a dividend payable in stock of the corporation and distributes cash in lieu of fractional shares to which shareholders would otherwise be entitled, or

(ii) Upon a conversion of convertible stock or securities a corporation distributes cash in lieu of fractional shares to which shareholders would otherwise be entitled.

Provided the purpose of the distribution of cash is to save the corporation the trouble, expense, and inconvenience of issuing and transferring fractional shares (or scrip representing fractional shares), or issuing full shares representing the sum of fractional shares, and not to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation. For purposes of paragraph (c)(1)(i) of this section, if the total amount of cash distributed in lieu of fractional shares is 5 percent or less of the total fair market value of the stock distributed (determined as of the date of declaration), the distribution shall be considered to be for such valid purpose.

(2) In a case to which subparagraph (1) of this paragraph applies, the transaction will be treated as though the fractional shares were distributed as part of the stock distribution and then

were redeemed by the corporation. The treatment of the cash received by a shareholder will be determined under section 302.

(d) *Adjustment in conversion ratio.*

(1)(i) Except as provided in subparagraph (2) of this paragraph, if a corporation has convertible stock or convertible securities outstanding (upon which it pays or is deemed to pay dividends or interest in money or other property) and distributes a stock dividend (or rights to acquire such stock) with respect to the stock into which the convertible stock or securities are convertible, an increase in proportionate interest in the assets or earnings and profits of the corporation by reason of such stock dividend shall be considered to have occurred unless a full adjustment in the conversion ratio or conversion price to reflect such stock dividend is made. Under certain circumstances, however, the application of an adjustment formula which in effect provides for a “credit” where stock is issued for consideration in excess of the conversion price may not satisfy the requirement for a “full adjustment.” Thus, if under a “conversion price” antidilution formula the formula provides for a “credit” where stock is issued for consideration in excess of the conversion price (in effect as an offset against any decrease in the conversion price which would otherwise be required when stock is subsequently issued for consideration below the conversion price) there may still be an increase in proportionate interest by reason of a stock dividend after application of the formula, since any downward adjustment of the conversion price that would otherwise be required to reflect the stock dividend may be offset, in whole or in part, by the effect of prior sales made at prices above the conversion price. On the other hand, if there were no prior sales of stock above the conversion price then a full adjustment would occur upon the application of such an adjustment formula and there would be no change in proportionate interest. Similarly, if consideration is to be received in connection with the issuance of stock, such as in the case of a rights offering or a distribution of warrants, the fact that such consideration is

taken into account in making the antidilution adjustment will not preclude a full adjustment. See paragraph (b) of the example in this subparagraph for a case where the application of an adjustment formula with a cumulative feature does not result in a full adjustment and where a change in proportionate interest therefore occurs. See paragraph (c) for a case where the application of an adjustment formula with a cumulative feature does result in a full adjustment and where no change in proportionate interest therefore occurs. See paragraph (d) for an application of an antidilution formula in the case of a rights offering. See paragraph (e) for a case where the application of a noncumulative type adjustment formula will in all cases prevent a change in proportionate interest from occurring in the case of a stock dividend, because of the omission of the cumulative feature.

(ii) The principles of this subparagraph may be illustrated by the following example.

Example. (a) Corporation S has two classes of securities outstanding, convertible debentures and common stock. At the time of issuance of the debentures the corporation had 100 shares of common stock outstanding. Each debenture is interest-paying and is convertible into common stock at a conversion price of \$2. The debenture's conversion price is subject to reduction pursuant to the following formula:

(Number of common shares outstanding at date of issue of debentures times initial conversion price) *plus* (Consideration received upon issuance of additional common shares) *divided by* (Number of common shares outstanding at date of issue of debentures) *plus* (Number of additional common shares issued)

Under the formula, common stock dividends are treated as an issue of common stock for zero consideration. If the computation results in a figure which is less than the existing conversion price the conversion price is reduced. However, under the formula, the existing conversion price is never increased. The formula works upon a cumulative basis since the numerator includes the consideration received upon the issuance of all common shares subsequent to the issuance of the debentures, and the reduction effected by the formula because of a sale or issuance of common stock below the existing conversion price is thus limited by any prior sales made above the existing conversion price.

(b) In 1972 corporation S sells 100 common shares at \$3 per share. In 1973 the corporation declares a stock dividend of 20 shares to all holders of common stock. Under the antidilution formula no adjustment will be made to the conversion price of the debentures to reflect the stock dividend to common stockholders since the prior sale of common stock in excess of the conversion price in 1972 offsets the reduction in the conversion price which would otherwise result, as follows:

$$100 \times \$2 + \$300 + 100 + 120 = \$500 + 220 = \$2.27$$

Since \$2.27 is greater than the existing conversion price of \$2 no adjustment is required. As a result, there is an increase in proportionate interest of the common stockholders by reason of the stock dividend and the additional shares of common stock will be treated, pursuant to section 305(b)(2), as a distribution of property to which section 301 applies.

(c) Assume the same facts as above, but instead of selling 100 common shares at \$3 per share in 1972, assume corporation S sold no shares. Application of the antidilution formula would give rise to an adjustment in the conversion price as follows:

$$100 \times \$2 + \$0 + 100 + 20 = \$200 + 120 = \$1.67$$

The conversion price, being reduced from \$2 to \$1.67, fully reflects the stock dividend distributed to the common stockholders. Hence, the distribution of common stock is not treated under section 305(b)(2) as one to which section 301 applies because the distribution does not increase the proportionate interests of the common shareholders as a class.

(d) Corporation S distributes to its shareholders rights entitling the shareholders to purchase a total of 20 shares at \$1 per share. Application of the antidilution formula would produce an adjustment in the conversion price as follows:

$$100 \times \$2 + 20 \times \$1 + 100 + 20 = \$220 + 120 = \$1.83$$

The conversion price, being reduced from \$2 to \$1.83, fully reflects the distribution of rights to purchase stock at a price lower than the conversion price. Hence, the distribution of the rights is not treated under section 305(b)(2) as one to which section 301 applies because the distribution does not increase the proportionate interests of the common shareholders as a class.

(e) Assume the same facts as in (b) above, but instead of using a "conversion price" antidilution formula which operates on a cumulative basis, assume corporation S has employed a formula which operates as follows with respect to all stock dividends: The conversion price in effect at the opening of